SOME IMPLICATIONS OF THE ADEQUACY OF MUTUAL FUND REGULATIONS.

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CHAPTER I

INTRODUCTION

Mutual funds have, in the past two decades, become one of the most popular investment mediums, especially for the small investor. Mutual funds have been the most rapidly growing segment of the financial intermediaries and this dramatic growth, continuing even today, has resulted in mutual funds becoming an investment medium of significance.[1] Because of this growth, much attention has been drawn to the adequacy of government regulations and the degree of investor protection provided mutual fund investors. There exists an extensive body of laws regulating the securities industry in general and the invesment companies in particular.[2] Several studies have been conducted to identify the major problems and regulation deficiencies surrounding the mutual fund industry.[3] Despite the statutory regulation presently applied to the mutual fund industry, there has always been a nagging, reoccurring doubt surrounding the adequacy of the regulatory measures applying to the management companies and management advisors who operate the many mutual funds. While no ra-

[1]See Chapter II, *infra*.

[2]See Chapter II, *infra*.

[3]See Chapter III, *infra*.

tional investor could expect protection against loss of capital as a result of market fluctuation, it is rational to expect maximum protection from fraud, bad faith, willful misfeasance, gross negligence, or reckless disregard by the managment organization in the performance of their obligations and duties. It is this area of management actions that is the subject of this Thesis.

Statement of Problem

The expansion of the mutual fund industry during the past two decades has occurred in both the number of shareholders and in the net asset value of the funds.[1] This great investor interest has precipitated the formation of several new mutual funds and a resultant increase in the number of personnel and organizations managing the mutual funds and their assets. When so many people are involved with responsibility for so large a concentration of investment funds, the question of adequate regulation and control of the industry is constantly being reexamined. The purpose of this research project is to determine if present Federal regulation of mutual fund management advisor groups is adequate for investor protection from fraud and general gross mismanagement of factors other than loss of principal.

The basic research question of this study is: Is pre-

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[1] Wiesenberger Services, Inc., Investment Companies 1970, (New York: Wiesenberger Services, Inc., 1970), p. 18.

sent Federal regulation of mutual fund management companies adequate for investor protection? This basic question suggests several subsidiary questions:

1. What has been the history of open-ended investment company regulation?
2. What are the current issues relating to mutual fund management company regulation?
3. How effective are existing regulatory measures that apply to managers of open-ended investment companies?
4. Do existing regulatory measures adequately protect investors?
5. Is there a need for additional regulation?

Scope of the Study

This research study will be directed primarily toward identity and analysis of existing regulatory measures applicable to management companies and investment advisors associated with mutual funds. The primary objective is to determine if the present body of Federal regulatory statutes provides reasonably adequate investor protection. The study will consider only those companies which are actively operating, managing, or providing investment advisory service to mutual funds. Mutual funds are more accurately labeled open-ended investment companies; however, within this report the terms mutual fund, open-ended investment company, and investment company will be used interchangeably.[1] The research study

[1]It is assumed that a definition and explanation of

will identify and review existing regulatory statutes, isolate applicable provisions that apply to regulation of mutual fund management companies, analyze the effectiveness and adequacy of the existing law, and determine if additional regulation of management companies is necessary in order to provide adequate investor protection. The research effort is directed toward measuring the adequacy of Federal regulations in providing shareholder protection from fraud, willful misfeasance, bad faith, gross negligence or reckless disregard by the management companies in their obligations and duties. The term gross mismanagement will be used as an all inclusive term for the management action under examination.

It is hoped that an analysis of the effectiveness of existing mutual fund management company regulation will afford an adequate basis for determination of what additional measures, if indeed there are any, are necessary in order that the individual mutual fund shareholder may be reasonably and adequately protected from fraud and gross misfeasance. This study is timely in the respect that the Congress passed into law the Investment Company Amendments Act of 1970.[1] This act amended the basic mutual fund regulatory statue, viz., the

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these terms is unnecessary for readers of this thesis. For further information on investment companies, their organization, operations, and structure, see Investment Companies 1970, by Wiesenberger Services, Inc., New York.

[1]Investment Company Amendments Act of 1970, 84 Stat. 1413 (1970).

Federal Investment Company Act of 1940.[1] It is timely and appropriate, therefore, to review the situation in light of the newly amended law and determine if the Federal body of regulatory law is adequate as it pertains to management companies of mutual funds.

The study is limited in that it considers only the Federal sector of regulation and disregards, for the most part, the role of State statutes. Further, the study analyzes only that part of the regulation system that applies to management companies. It is further limited in scope to only those management companies that are associated with open-ended investment companies. Therefore, it is not intended that statements contained in this research study be applicable to all regulatory issues or all investment companies. It should also be noted that this study does not consider the items of investor protection from the loss of capital or the "performance" of mutual fund management companies.

Methodology of Study

Information and data for this study was derived from secondary sources including SEC studies, independent studies, Senate and House reports, and contemporary books written about the mutual fund industry. Other sources were textbooks, articles, financial newspapers, industry reports, and investment

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[1]Investment Company Act of 1940, 54 Stat. 789 (1940) 15 U.S.C. Sess. 80(2)-1 to -52 (1964).

company letters, publications, and financial reports. The information was obtained from the Geroge Washington University library, the Fairfax County library, the Library of the Securities and Exchange Commission, and the Public Document Rooms of the United States Congress. The analysis in the report is primarily deductive.

Organization of the Study

Entitled "Some Implications of the Adequacy of Mutual Fund Regulation," this research report contains, in Chapter II, a listing of mutual fund development and traces the evolution and development of investment company regulation in the United States. Chapter III reviews the past studies and identifies the current issues concerned with determining the adequacy of present regulatory measures. Chapter IV analyses the effectiveness and adequacy of current regulation as well as the unresolved current issues and their relationship to existing regulatory laws. A summary and conclusions are presented in Chapter V.

CHAPTER II

HISTORY OF MUTUAL FUND DEVELOPMENT AND REGULATION

What is a mutual fund? The phrase "mutual fund" is a somewhat colloquial term for what, technically and more descriptively, is an open-ended investment company. As stated in Chapter I, these two terms will be used interchangeably herein. Nothing could be simpler than the basic idea of an investment company. It is a corporation whose only business is the proper investment of its shareholders' money. These assets are normally invested in common stocks or a combination of equities and bonds, in the hope of achieving a specific investment goal. A mutual fund brings together the investment funds of many people with similar needs and purposes, and undertakes to do a better job of investing these funds and managing the investments than individuals could do for themselves.

Mutual funds are limited by law to only offering one class of shares. A mutual fund's share total fluctuates from day to day because, in most cases, the fund is constantly creating new shares for investors who wish to purchase them, and in all cases is ready to buy back shares already in existence at whatever specific amount they are worth at the time. In other words, a mutual fund's capitalization is "open" at least on one end and generally is open at both ends. Mutual fund shares are traded over the counter by dealers and brokers

who are compensated by the fund management for their services. Although numerous distinctions are necessary for a complete understanding of all that investment companies and mutual funds offer, the purpose of this research is not to describe the structure of the industry, but rather to investigate the adequacy of Federal regulations of the management companies employed by the mutual fund organizations.[1] Returning to the first subsidiary question, an examination of the history of mutual funds and their growth in the United States is appropriate.

History of Mutual Funds and Their Growth in the United States

While many modern business innovations have originated in the United States, Europe was the birthplace of investment companies. The origin, it is generally agreed, can be traced to the Societe Generale de Belgique, formed in 1822 by King William I of Belgium.[2] However, the major development of investment companies took place in England, beginning in 1868 with the formation of the Foreign and Colonial Government Trust in London. This trust had as its purpose the diminishing or diversifying of risk in the purchase of foreign and

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[1]For further information concerning investment companies, their organization, purpose, and operation, the first section of Investment Companies, 1970 is recommended. Investment Companies is published by Arthur Wiesenberger Services, New York.

[2]Hugh Bullock, The Story of Investment Companies (New York: Columbia University Press, 1959), p. 1.

colonial government securities, engaged in other financing or banking activities, and can be said--insofar as research indicates--to be the true pioneer of investment companies.[1] The early British trusts were conservative, emphasized income, and practiced wide diversification. Most purchased commonwealth and foreign government securities while issuing stock similar to what is known today as common, preferred, and debenture bonds.[2] During this period, a bookkeeper, Robert Fleming, in Dundee, Scotland, became interested in investment opportunities in the post-Civil War United States. Mr. Fleming's enthusiasm resulted in the formation of a new investment company, in 1873, and the beginning of a long and distinguished association with the investment company industry of which he will always be called the father.[3]

The first American experience with investment trusts probably occurred in the mid-1800's; however, the ventures were small and have been lost in the haze of the years. The oldest investment company in the United States still in existence is the Boston Personal Property Trust, organized in Boston in 1893.[4] Development of investment companies was

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[1] Ibid., p. 2.

[2] Elvin F. Donaldson and John K. Pfahl, Corporate Finance, 2nd ed., (New York: The Ronald Press Company, 1969), p. 680.

[3] Bullock, Story of Investment Companies, pp. 5-8.

[4] Ibid., p. 15.

slow during the next two decades. Not until the mid- and late-1920's did investment company formation begin in earnest. March, 1924 saw the birth of the first open-ended investment company, or mutual fund, in this country with the formation of Massachusetts Investors Trust in Boston.[1] While MIT has survived the years and been a credit to the industry, many of the other investment companies formed in the late 1920's were not as fortunate. The market crash of 1929 brought the expansion of investment companies to an abrupt halt. The ensuing depression saw many of the investment companies fail and others consolidated into larger units after being bought up for relatively low prices. Following the depression, which saw the soundly conceived and well managed investment companies survive in moderately good shape, a slight resurgence of investment companies occurred; however, expansion was very modest until after the end of World War II. One individual who survived the depression to go on toward pioneering the open-ended investment company industry in the United States was Calvin Bullock.[2] Probably more than any other individual Mr. Bullock was the major factor in developing the mutual fund industry in the United States.

There were only nineteen open-ended investment com-

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[1] *Ibid.*, pp. 21-23.

[2] *Ibid.*, pp. 23-24

panies with total assets of around $140 million at the end of 1929.[1] This figure decreased during the depression years, but by 1940 the industry had recovered to where assets totaled $448 million.[2] The decade of the 40's saw the beginning of rapid mutual fund growth. By 1950 there were approximately 100 registered companies with combined assets of $2.5 billion.[3] The development and growth of mutual funds since 1950 is reflected by the data in Table I.

TABLE 1

Growth of Investment Company Assets Since 1950

YEAR	MUTUAL FUND ASSETS (000 omitted)
1970	$47,618,100
1968	52,677,188
1966	34,829,353
1964	29,116,254
1962	21,270,735
1960	17,025,684
1958	13,242,388
1956	9,046,431
1954	6,109,390
1952	3,931,407
1950	2,530,563

SOURCE: Investment Company Institute, 1971 Mutual Fund Fact Book (Washington, D. C.: Investment Company Institute, 1971), p. 16.

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[1] Ibid, p. 41.

[2] Wiesenberger Services, Inc., Investment Companies 1970 (New York: Wiesenberger Services, Inc., 1970), p. 13.

[3] Ibid, pp. 13 and 18.

There were, in 1970, over 517 registered open-ended investment companies operating in the United States. This represents a 417 percent increase during the twenty-year period from 1950 to the end of 1969. Asset values rose from $2.5 billion in 1950 to $47.6 billion at the end of 1970, or over 1,800 percent. The present size and types of mutual funds are reflected in Table 2.

TABLE 2

Classification of Mutual Funds by Size and Type
(As of December 31, 1969)

Size of Fund	Number of Funds	Combined Assets (000 omitted)	% of Total
Over One Billion	12	$19,323,100	36.7
$500 Million-$1 Billion	14	9,516,500	18.1
$300 Million-$500 Million	12	4,425,500	8.4
$100 Million-$300 Million	58	10,204,100	19.4
$ 50 Million-$100 Million	65	4,752,200	9.0
$ 10 Million-$ 50 Million	153	3,735,900	7.1
$ 1 Million-$ 10 Million	156	614,700	1.2
Under One Million	47	21,400	0.1
Total	517	$52,621,400	100.0

Size of Fund	Number of Funds	Combined Assets (000 omitted)	% of Total
Common Stock:			
Maximum Capital Gain	180	$ 8,304,600	15.8
Growth	136	17,234,700	32.8
Growth and Income	80	16,514,400	31.4
Specialized	20	335,600	0.6
Balanced	30	6,484,000	12.3
Income	34	2,139,900	4.1
Tax-Free Exchange	29	1,325,600	2.5
Bond and Preferred Stock	8	282,600	0.5
Total	517	$52.621,400	100.0

SOURCE: Wiesenberger Services, Inc., Investment Companies 1970 (New York: Wiesenberger Services, Inc., 1970), p. 44

Another indication of the growing acceptance of mutual funds by the investing public is shown in Table 3 which depicts the growing number of shareholder accounts over the past twenty years. While some investors will establish accounts in more than one fund, the data in Table 3 does show over a tenfold increase in shareholder accounts and it seems logical to assume that a large measure of this growth represents new mutual fund investors.

TABLE 3

Increase in Number of Shareholder Accounts Since 1950

YEAR	MUTUAL FUND SHAREHOLDER ACCOUNTS
1970	11,018,536
1968	9,080,168
1966	7,701,656
1964	6,301,908
1962	5,901,455
1960	4,897,600
1958	3,630,096
1956	2,518,049
1954	1,703,846
1952	1,359,000
1950	938,651

SOURCE: Wiesenberger Services, Inc., Investment Companies 1970 (New York: Wiesenberger Services, Inc., 1970), p. 18 for years 1950-1968. Data for 1970 from Investment Company Institute, Washington, D. C.

The data contained in Tables 1 and 3 illustrates that the growth of the mutual fund industry over the past twenty years has been large and rapid. This observation is reinforced by the fact that mutual fund growth has far surpassed the growth of other financial intermediaries. Only credit unions have been able to approach the twentyfold growth rate

of mutual funds for the past twenty years.[1]

The effect of a rapidly expanding mutual fund industry on the savings and investment practices of individuals as well as the securities markets has been pronounced. The rapid growth rate along with the magnitude of the capital involved have raised serious questions concerning the degree of government regulations necessary to provide proper protection for the investment public. The concern centered around protecting the investing public, particularly the small investor, has given rise to many of the present regulatory statutes. Further, it is the same concern which is the root of the research question under examination herein.

Evolution of Investment Company Regulation

Because the regulation of investment companies is inseparably tied with that for the securities industry as a whole in the United States, this section will outline the evolution of regulations for the whole securities industry with special emphasis being placed on those regulatory functions applying to investment companies.

Regulation of investment processes and security dealing was almost nonexistent prior to 1930. What few regulations existed were contained in state laws which varied widely and, while applying to investment companies, did not refer

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[1]Merritt Lee Murry, "Mutual Fund Reform: Will Further Regulation be Necessary for Investor Protection by 1975?," (Unpublished MBA Thesis, George Washington University, 1970), p. 15.

to them by name. Research indicates the first regulatory effort to deal with investment companies per se was in 1927 when the Attorney General of the state of New York conducted an investigation that culminated in draft legislation proposing regulation of the then predominant investment trusts. The proposed bill, after many changes in point of view, passed the state Senate, but failed of passage in the Assembly.[1] Other states did pass legislation dealing with investment companies; however, the attitude toward trusts, as investment companies were then known, was very inconsistent. The same practice commended in one state was frowned upon in another.[2] By 1929 many states had either adopted some limited regulations toward investment companies or were investigating the possibility of so doing. These pre-legislation investigations revealed abuses and excesses along with the exercise of fraud being practiced in the sale and management of investment company securities. Another factor contributing to the acceptance of regulatory measures was the underlying distrust and fear of bigness in economic matters. Investment companies were getting larger, along with other security industry firms in the 1920's, and Main Street believed some control over Wall Street, particularly a growing

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[1]William H. Steiner, Investment Trusts, American Experience (New York: Adelphi Company, 1929), pp. 301-302.

[2]Ibid., p. 302.

Wall Street, was desirable.[1]

The immediate stimulus to government regulation of the securities industry was the stock market debacle of 1929. Both private and governmental investigations during the depression that followed disclosed a large measure of unethical practices, negligence, and outright fraud to have been present prior to the crash. The state laws had certainly proven inadequate. The experiences of the twenties clearly revealed the necessity for some regulation. Some measure of regulating the information presented to purchasers of securities was deemed desirable in order to overcome the situation where information supplied purchasers of securities was truthful, but not adequate. Also, some discrimination was necessary between losses resulting from misleading statements and from market declines. The result of all the investigations, studies, and varied proposals offered as a result of the 1929 market crash stimuli was the enactment of a series of Federal laws designed to remedy the abuses, both real and imaginary, prevailing during the 1920's. The legislation enacted in the decade of the 1930's has provided a securities market that is now a market controlled from many aspects by government agencies. The Federal regulatory measures having applicability to investment companies may be grouped as follows:

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[1]Willard E. Atkins, George W. Edwards, and Harold G. Moulton, The Regulation of the Security Markets (Washington, D. C.: The Brookings Institution, 1946), p. 44.

Federal Securities Act of 1933

Federal Securities Exchange Act of 1934

Investment Advisors Act of 1940

Investment Company Act of 1940

Federal Securities Act of 1933

The Federal Securities Act of 1933 was the first of the major Federal acts passed during the decade of the 1930's.[1] This Act has sometimes been called the "Truth in Securities" Act.[2] Its purpose is to insure that adequate information which a prudent investor should know concerning an offered security is made available to all prospective purchasers.[3] The Act deals with the initial public distribution of a securities offering and provides that such distribution may occur only after a Registration Statement has been filed with and approved by the Securities and Exchange Commission. The Registration Statement sets forth a great deal of material information about the issuing corporation. A part of the Registration Statement is the Prospectus which must accompany all written offers of sale and be provided to all actual purchasers of the securities. Approval of the Registration Statement by the SEC does not constitute approval or recommendation of the

[1] Securities Act of 1933, 48 Stat. 74 (1933), 15 U.S.C. sec. 77(a) (1964).

[2] Allen D. Choka, An Introduction to Securities Regulation (Chicago: Twentieth Century Press, Inc., 1958), p. 23.

[3] Ibid.

security by the government agency; it merely certifies the issuer of the securities has met the lawful disclosure requirements and the security is authorized to be offered for sale. Civil and criminal liabilities are imposed for false or misleading statements in the Registration Statement. Also, there are certain classes of security issues that are exempt from the Act. The exempt classes are small issues, entirely intrastate issues, government issues, security dealer inventory issues, and nonpublic offerings.[1] In general, the 1933 Act is not concerned with subsequent trading in a particular security once the initial distribution to the public has occurred.

Of all the Federal regulatory laws, the Securities Act of 1933 is the one of most importance governing the sale of investment company securities. Virtually all mutual funds of any size are subject to the provisions of the 1933 Act when selling new securities to the public. The investment company is required to file a Registration Statement with the SEC and obtain their approval prior to consumating sales with the public. A prospectus, submitted to the SEC as a part of the Registration Statement, must be provided each purchaser of an investment company's shares. Although oral offers to sell a new security may be made before the SEC allows the Registration Statement to become effective, any written offer of sale

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[1] *Ibid.*, pp. 23-32.

must be accompanied by a prospectus. Any changes occurring or proposed in the investment company which alters any information contained in the original Registration Statement must be filed with the SEC, and if affecting the prospectus sections also provided the public shareholders. The Federal Securities Act of 1933 serves a very useful function by requiring disclosure of the information required for prudent investment decisions. While the Act requires that this information be made available to the prospective investor in mutual funds, or any other security offering, it cannot insure the data is accurate or that the investment is a desirable one. SEC approval of a security offering means only that the issuing orgnanization has complied with the law by disclosing all the information required. This represents a giant step forward for investor protection from the situation that existed in the pre-1929 era and has been one of the factors contributing to the acceptance of mutual fund companies by the investing public since 1940.[1]

Federal Securities Exchange Act of 1934

The second of the major Federal acts controls, in many ways, the activities of the securities markets in their daily operations.[2] The Act is actually much broader than its name

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[1]See discussion of the growth of mutual funds on page 11 and Table 1 *supra*.

[2]Securities Exchange Act of 1934, 48 Stat. 881 (1934), 15 U.S.C. sec 78(a) (1964).

implies in that it goes further in its control and regulatory powers than just the security exchanges. The following list summarizes the major effects of the 1934 Act.

- National securities exchanges must register with the SEC and they and their members are subject to SEC discipline.
- A corporation whose stock is listed on a national exchange must register with the SEC and furnish periodic reports to the SEC.
- The directors, officers, and other "insiders" of a corporation must disclose their trading in the corporation's securities and may not make "short-swing" profits in the corporation's securities or sell such securities short.
- The management of a corporation whose securities are listed on a national securities exchange can solicit proxies for shareholders' meetings only under rules presecribed by the SEC.
- Market stabilization, manipulation, and fraud is prohibited of all persons.
- Brokers and dealers in securities are subject to SEC discipline and may engage in their business only pursuant to SEC rules.
- Brokers, dealers, and banks may extend credit for buying or carrying securities only under regulations prescribed by the Federal Reserve Board.[1]

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[1]Choka, Securities Regulation, p. 40.

As can be observed from the above listing, the operational effect of the Securities Exchange Act of 1934 is indeed great. The Act contains provisions for the regulation of short sales, insider trading, listing and delisting of securities on exchanges, unlisted trading, market manipulation, fraud, discipline of exchanges and their remedies, and several special rules concerning brokers and dealers. Further, the rules set forth on proxy regulation and management actions concerning solicitation and voting of proxies along with notification of shareholders of annual meetings is of value to every investor.

While not all of the provisions of the Securities Exchange Act apply directly to investment companies, a great measure of regulation and investor protection does accrue to mutual fund shareholders from the provisions of the 1934 Act. The direct benefits are the anti-fraud and market manipulation provisions, the control exercised over the brokers and dealers, the insider trading and disclosure section, and the proxy regulation. Indirect benefits of the Act for the mutual fund investor are the requirements for registration, the control of exchanges, the reporting requirements, and the disciplinary role of the SEC which helps keep the whole securities industry as well as investment companies in compliance with this and other Federal regulatory statutes. Although investment companies are not the direct object of this law, they do fall within several of its provisions and the result is substantial investor protection for the mutual fund shareholder.

Investment Advisors Act of 1940

Those persons and organizations that hold themselves out to the public as being in the business of offering investment advice and counsel must comply with the Investment Advisors Act of 1940.[1] Compliance is required no matter whether the advice is offered personnaly, by letter, or by bulletin or reports. Anyone wishing to be registered as an investment advisor must register with the SEC, is prohibited from entering into profit sharing arrangements with clients, may not assign his contracts with clients to others, and must abstain from engaging in fraudulent practices.[2] Registration by the SEC does not constitute approval of or recommendation of the advisor by the SEC, but merely that the advisor has registered and is complying with the provisions of the 1940 Investment Advisors Act. The Act also contains specific exemptions which precludes bankers, brokers and dealers, trustees, and small professional investment advisors from having to register. The major effect of the Investment Advisors Act on the mutual fund industry is the regulation under the Act of those individuals or organizations who manage the investment of mutual fund assets or who advise and offer investment policies.

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[1]Investment Advisors Act of 1940, 54 Stat. 850 (1940), 15 U.S.C. sec 80(b) (1964).

[2]Choka, Securities Regulation, p. 3.

Investment Company Act of 1940

The most complex of the Federal securities acts is the one dealing with investment companies.[1] Mutual funds, investment trusts, and closed-end investment companies are all covered by this Act which controls their activities in minutiae. In fact, very few of their activities are not subject to some degree of control under this Act. It was the intent of Congress to set forth, in detail, the requirements it considered necessary for adequate regulation of these companies.[2] The Investment Company Act of 1940 supplements the other state and Federal laws and provides a comprehensive system of regulation for investment companies. Regulatory protection is aimed at preventing certain abuses and eliminating conflicts of interest on the part of those managing investment companies. The law deliberately avoids attempting to interfere with management's exercise of honest business judgment in the selection of the company's investments, and in no sense does it purport to assure an investor against loss.

The objectives of the 1940 Act were developed in the light of past abuses and difficulties as found by a Congressionally directed study.[3] The Act is intended to do these

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[1]Investment Company Act of 1940, 54 Stat. 789 (1940, 15 U.S.C. secs. 80(a) -1 to -52 (1964).

[2]Choka, Securities Regulation, p. 81.

[3]Securities and Exchange Commission, Investment Trusts and Investments Companies (Washington, D. C.: Government Printing Office, 1939-1940).

things:

1. Provide investors with complete and accurate information concerning the character of investment company securities and the circumstances, policies, and financial responsibility of investment companies and their management;

2. Assure that investment companies are organized and operated in the interest of all shareholders rather than in the interest of officers, directors, investment advisors, or other special groups or persons;

3. Prevent inequitable provisions in investment company securities and protect the preferences and privileges of outstanding securities;

4. Prevent undue concentration of control through pyramiding or other devices, and discourage management by irresponsible persons;

5. Assure sound accounting methods;

6. Prevent major changes in organization or business without the consent of shareholders; and,

7. Require adequate assets or reserves for the conduct of business.[1]

The Act contains specific provisions designed to achieve those broad aims. Among them are: definiton, regulation, and registration requirements for investment companies; requirements that there be at least a minimum of independent managers or "outsiders" on the board of directors--meaning persons not

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[1]Wiesenberger, Investment Companies, 1970, p. 25.

otherwise connected with the management; limitations on the amount of indebtedness that may be incurred by the investment company; certain financial management regulations; limitations on the types of stock which may be issued; provisions to assure shareholders of participation in certain management decisions; requirements for management to comply with SEC rules in soliciting proxies for voting on company matters; explicit policies concerning disclosure and financial statements; insider trading limitations; provisions requiring shareholder approval of changes in fundamental investment policy; and, requirements concerning underwriting and management contracts. In addition, the Act contains a tax benefit provision for qualifying registered investment companies. Very few facets of mutual fund operation escape regulation by the Investment Company Act of 1940 as amended. The most recent amendment occurred in 1970 with changes being made in the provisions applying to management fees, salesmen's commissions, and front-end load funds.[1] These areas will be discussed further in Chapter III.

The 1940 Investment Company Act is the single most important statute concerned with the protection of the mutual fund investor. The Act encompasses the entire industry and its many facets. It attempts to correct the abuses and excesses found in the investment company industry in the 1920's.

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[1] Investment Company Amendments Act of 1970, 84 Stat. 1413 (1970).

The Act is a landmark example in the protection it affords the individual investor and when coupled with the other Federal and state laws, provides a sound framework of regulation for the industry. Certain provisions of the regulatory statutes state that specific functions are to be self-regulated by the industry. This is normally carried out through the voluntary professional organizations.[1] One of the key parts to the research question being considered in this thesis is the adequacy and dependability of the existing regulatory measures, particularly the self-regulated areas, as they apply to the management companies in the mutual fund industry. Considerable emphasis is placed on self-regulation in the mutual fund industry thereby making it a subject of concern to the individual investor.

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[1]The more well known of these organizations are: NASD--The National Association of Securities Dealers; ICI--Investment Company Institute; and, the Association of Mutual Fund Plan Sponsors.

CHAPTER III

IDENTIFICATION OF CURRENT REGULATORY ISSUES

Identification of specific issues which are current and which relate to the regulation of mutual funds and particularly to fund managers is necessary and will constitute the next step in this analysis. Issues which are currently at the forefront of discussions concerning regulation of the mutual fund industry will be isolated for further analysis in Chapter IV. Because of the large number of separate issues, not all those identified will receive further analysis; however, specific issues concerned primarily with the regulation of the management companies associated with mutual funds will be considered in detail. In addition, several other regulatory issues will receive mention as they are ancillary to the specific research question of this paper.

Any identification process and analysis of issues relevant to regulation of the investment company institutions should properly begin with a review of the several studies that have been conducted over the last decade. Primarily resulting from Congressional concern about the adequacy of Federal regulation of the institutional investment community several in-depth studies exist that were conducted during the 1960's which provide rich sources of information. These studies will be reviewed with a view toward identification of those

regulatory issues of interest to this thesis.

Wharton Report

In 1958, the SEC authorized the Securities Research Unit of the Wharton School of Finance and Commerce of the University of Pennsylvania to make a study pursuant to section 14(b) of the Investment Company Act of 1940, and to submit a report to the Commission. The report was delivered to the SEC and submitted to Congress in 1962.[1] The *Wharton Report* represented the most comprehensive analysis of the mutual fund industry since the Commission's *Investment Trust Study* which led to the enactment of the Investment Company Act of 1940.[2] Through the use of detailed questionnaires, data was compiled on the functional characteristics and market impact of 189 mutual funds in operation during the target periods of the study: from 1952 to 1958, and during 1960. The report presented much factual material about mutual funds and identified areas in which problems appeared to exist. The information gathered dealt with these major areas: (1) growth of mutual funds; (2) organization and control of mutual funds; (3) investment policy; (4) investment company performance; (5) trading impact on the stock market; (6) portfolio company

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[1]U.S. Congress, House, Wharton School of Finance and Commerce, *A Study of Mutual Funds*, H.R. 2274, 87th Cong., 2nd sess., 1962. (Hereinafter referred to as the *Wharton Report*.)

[2]Securities Exchange Commission, *Investment Trusts and Investment Companies* (Washington, D.C.: Government Printing Office, 1939-40).

control; and, (7) investment advisors of mutual funds.[1] The report concluded that:

> . . . there is little evidence that size per se of individual funds or companies is a problem at the present time, and the more important current problems in the mutual fund industry appear to be those which involve potential conflicts of interest between fund management and shareholders, the possible absence of arm's length bargaining between fund management and investment advisors, and the impact of fund growth and stock purchases on stock prices.[2]

The major conclusions of the Wharton Report are summarized as follows:

1. Growth of Mutual Funds

   A. The number of funds, number of shareholders, and net asset value of funds showed a steady and vigorous increase during the period of the study. This is a continuation of the rapid growth rate of the mutual fund industry, beginning in the 1930's.

   B. Smaller funds grew relatively more rapidly than the larger funds.[3]

2. Organization and Control of Mutual Funds

   A. A large majority of mutual fund organizations are corporations and almost all contract with outside organizations to function as investment advisors.

   B. While control technically resides in the voting rights

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[1] Wharton Report, pp. 4-36.

[2] Ibid., p. X.

[3] Ibid., pp. 4-6, 84.

of the shareholders (ownership control), the environment of the mutual fund industry is strongly conducive to "management control."

C. Active management of most open-ended investment companies is delegated by the board of directors to an investment advisor. Persons affiliated with the investment advisor often become the "management control group" and select directors also affiliated or related to the investment advisor. This raises questions concerning the extent to which independent directors are actually independent and committed to safeguarding the rights of shareholders in negotiations between the investment company and the investment advisor.[1]

3. Investment Policy

A. During the period of the study approximately 75 percent of the total net assets of funds was held in United States common stocks. The remainder was evenly spread among United States corporate bonds, United States preferreds, foreign securities, and net liquid positions.

B. Small funds hold larger relative liquidity positions than do large funds.

C. Differences in announced investment objectives account for the principal differences in portfolio distributions among funds.

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[1] Ibid., pp. 6-9.

D. Funds practice portfolio diversification, tend toward issues traded on the New York Stock Exchange, and exhibit turnover rates inversely related to size with the smallest funds having the higher turnover rates.[1]

4. Investment Company Performance

A. When adjustments are made for portfolio composition, the average performance of mutual funds did not differ appreciably from what would have been achieved by an unmanaged portfolio (i.e., Standard and Poor's Composite Common Stock index) with the same division among asset types.[2]

5. Impact on the Stock Market

A. Mutual funds have played a contributory role in stimulating stock prices markedly during the decade preceding the study.

B. There is weak evidence that net purchases by mutual funds significantly affect the month-to-month movements in the market as a whole. There is stronger evidence that fund net purchases significantly affect the daily movements in the stock market.[3]

6. Portfolio Company Control

A. Few mutual funds approach the maximum holdings in a

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[1] *Ibid.*, pp. 9-16.

[2] *Ibid.*, pp. 16-21.

[3] *Ibid.*, pp. 21-23.

single portfolio company allowable by the Act of 1940. Management of mutual funds seem content to emphasize investment management rather than participate in management of portfolio companies.[1]

7. Investment Advisors of Mutual Funds

A. There are three principal and inter-related sources of income and other benefits that accrue to investment advisors and affiliated persons maintaining effective control over mutual funds: (1) advisory and management fees; (2) payments for selling activities in the wholesale and retail distributions of mutual fund shares; and, (3) brokerage commissions for the purchase and sale of portfolio securities for the account of the investment company.

B. Advisory fee rates charged mutual funds average around one half of one percent per annum of average net assets. This rate tends to be substantially higher than the rates charged by the same advisors to their other clients for comparable asset levels.

C. A conflict of interest situation may exist between management and shareholder in the area of selling fund shares.

D. The sale of fund shares is a large factor in allocation of the funds brokerage by the advisor.

E. Give-ups are utilized to reward dealers for sales of

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[1] *Ibid.*, pp. 24-27.

fund shares and tend to limit the flexibility of the rate structure for large transactions.[1]

The findings of the Wharton Report appear to indicate that possible conflict of interest situations between management and shareholders exist; shareholders have little negotiating leverage with the management control group; and, it raises questions as to the extent that independent directors are actually independent and committed to the best interests of the shareholders.

Special Study

During 1961, while the Wharton Report was being prepared, Congress added section 19(d) to the Securities Exchange Act of 1934, which authorized and directed the Securities and Exchange Commission to undertake a detailed study of the securities business and the securities markets. The object of the study was to determine the adequacy of the rules of the national securities exchanges and national securities associations for the protection of investors. The study resulted in a five part report, known as the "Special Study," which was submitted to Congress during 1962 and 1963.[2]

The Special Study treated aspects of the mutual fund industry which fell outside the scope of the Wharton Report

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[1] Ibid., pp. 28-33.

[2] U.S. Congress, House, Report of the Special Study of the Securities Market, H.R. 95, 88th Cong., 1st sess., 1963. (Hereinafter referred to as the Special Study.)

The major areas of concern were: (1) selling practices; (2) allocation of mutual fund portfolio brokerage; and, (3) insider transactions in portfolio securities. The major conclusions of the Special Study are as follows:

1. Selling Practices:

    A. Certain factors peculiar to the mutual fund industry create pressures toward undesirable selling practices. A consorted effort by the industry, trade associations, and the SEC should be undertaken to eliminate undesirable selling tactics and devices through adoption of Rules of Fair Practice. Secondary supervisory controls by industry members are also desirable.

    B. Prospectus requirements should be refined to assure that all basic information is presented clearly and conspicuously brought to the attention of the prospective investor.

    C. Legislation should be proposed to abolish or greatly modify the front-end load feature and other items relating to contractural plans.[1]

2. Allocation of Portfolio Brokerage:

    A. The economies of the value of securities transactions generated by the mass purchasing power of the funds are of minor benefit to the funds themselves. The

[1] Ibid., p. 212.

primary beneficiaries are their investment advisors and their frequently related principal underwriters, who use reciprocity to reward sales efforts of fund retailers thereby increasing their own rewards.

B. The give-up in its various forms is in conflict with the duty of a fund and its advisor to obtain best terms in their securities transactions.[1]

C. Mutual fund directors, investment advisors, and operating officials who carry out portfolio business for the fund are primarily obligated to obtain the best available terms in such transactions for the benefit of fund shareholders without regard to the reciprocal business aspects of the transactions, and to see that the funds themselves receive the maximum benefits available from any such reciprocal business. The choice of market should be made exclusively from this point of view and not on the basis of rewarding broker-dealers for their sales efforts.[2]

3. Insider Trading:

A. Close regulation of insider trading in accordance with with SEC approved policy should be required of each registered investment company.[3]

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[1]For a detailed discussion of the give-up issue see Chapter IV, *infra*.

[2]*Special Study*, pp. 234-235.

[3]*Ibid.*, p. 255.

The *Special Study*, while dealing with the securities markets as a whole, resulted in proposed adjustments to the regulation of mutual funds in order to eliminate abuses and increase investor protection in the areas of selling, brokerage allocation, and insider trading.

Public Policy Report

This report was submitted to Congress in 1966. The study represented the first report by the SEC to Congress on the subject of Investment Company regulation since the passage of the 1940 Act. Neither the *Wharton Report* nor the *Special Study* was a report by the Commission. Rather, the *Wharton Report* was a report to the SEC, not by the SEC, and was an analytical study that made no recommendations for legislative action. The *Special Study*, on the other hand, did contain recommendations; but, those were the recommendations of the staff which prepared the Study--not of the Commission. It remained for the Commission to evaluate the public policy questions that were raised by the publication of the two preceding reports. A comprehensive review of the *Special Study* recommendation against the background of the basic questions raised by the *Wharton Report* and the SEC's own experience in administering the Federal securities statutes resulted in the Commission transmitting its legislative proposals to Congress in a report known as the *Public Policy Implications of Invest-*

ment Company Growth.[1]

The Public Policy Report sought to test the conclusions of the Wharton Report and the Special Study by an intensive first hand examination of a cross section of the investment company industry. The scope of the study was focused on the areas where mutual fund growth had raised questions as to the adequacy of the existing regulatory pattern. The specific matters analyzed in the report, in addition to a general review of the mutual fund industry, are: (1) management function and its cost; (2) portfolio transactions; (3) distribution and its cost; (4) mutual fund size and investment performance; (5) investment company growth and market impact; and, (6) investment company relationships with portfolio companies.[2]

The Public Policy Report asked for legislation to strengthen the regulatory system applying to the mutual fund industry. The specific changes recommended and proposed in legislation were:

1. Place a 5 percent ceiling on mutual fund sales charges that currently were averaging 9.3 percent on dollars invested.
2. Enact a "standard of reasonableness" for management fees

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[1]U.S. Congress, House, Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H.R. 2337, 89th Cong., 2nd sess., 1966. (Hereinafter referred to as Public Policy Report.)

[2]Ibid., pp. 6-32.

that currently average one half of 1 percent per annum of net assets.

3. Eliminate "front-end load" contractural plans.
4. Ban mutual fund holding companies.
5. Prohibit give-ups of brokerage fees.
6. Establish a procedure for granting volume discounts.
7. Closely regulate and police insider trading to insure that fund managers do not take advantage of inside information concerning the fund's investment plans or practices.
8. Take a more active interest in portfolio companies by prohibiting the sale of any company that manages a mutual fund if the ownership change might burden the fund's shareholders or limit the future action of the fund.

The fate of the proposed regulatory changes, following their submission to Congress, is discussed below. The Public Policy Study remains the most recent document consisting of the SEC's recommendations concerning the adequacy of Federal regulation statutes in providing protection for the mutual fund investor.

Legislative Action

The SEC followed up its Public Policy Report by presenting to Congress, in May, 1967, its proposed bill--the Investment Company Amendments Act of 1967.[1] While containing many technical changes, the bill proposed the major amend-

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[1]S. 1659, 90th Cong., 1st sess., (1967).

ments deemed desirable by the SEC as highlighted in the Public Policy Report. These amendments asked specifically for a standard of "reasonableness" in respect to management fees which would be enforceable in the courts; a ceiling of 5 percent of asset value on sales charges; and, the outlawing of new contractural plans. A later amendment would have permitted banks to enter the mutual fund business.[1] The drastic recommendations of the SEC's report, and the bill which sought to put them into effect, were not accepted by the Commerce and Finance Subcommittee of the House Committee on Interstate and Foreign Commerce or the Senate Committee on Banking and Currency, the Congressional committees, under whose jurisdiction the proposal rested. A bill was passed in the Senate which retained the standard of reasonableness as to management fees, left the question of sales charges to a study and disposition by the National Association of Securities Dealers, permitted a "stretch-out" of commissions on contractural plans so that such levies could not exceed 64 percent of the amount invested in the first four years, and permitted the entry of banks into the mutual fund business.[2] While there were extended hearings on the SEC's proposals before the House sub-

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[1]This provision was not included in the subsequent legislation that became law. Further, a Supreme Court ruling of April 5, 1971 declared that banks cannot legally enter the mutual fund industry because operation of "investment accounts" (another term for mutual fund) by banks would be in violation of the Glass-Steagall Banking Act of 1933.

[2]Wiesenberger, Investment Companies, 1970, p. 26.

committee, no action was taken by the House.

In 1968, a bill similar to the 1967 bill was introduced in the Senate by Senator John Sparkman.[1] The bill, known as the Investment Company Amendments Act of 1968, passed the Senate by voice vote in July, 1968, after two days of debate. In September, 1968, the House Commerce Committee decided not to consider the measure.

January, 1969 saw two bills introduced in the Senate relating to mutual fund regulation. The first was the Sparkman Bill, which was the same as that which Senator Sparkman had introduced in the previous year and which had passed the Senate.[2] The second was introduced by Senator Thomas J. McIntyre, a member of the Senate Banking and Currency Committee of which Senator Sparkman is Chairman.[3]

The McIntyre Bill differed drastically from the Sparkman Bill. It asked for repeal of Section 22(d) of the Investment Company Act of 1940, the so-called "price maintenance" provision of the Act that serves to maintain an orderly market in mutual fund shares and prevents price discrimination between investors. Senator McIntyre also asked for the abolition of contractual plans and a change in the basis for action against an advisor or underwriter from "gross misconduct or

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[1]S. 2724, 90th Cong., 2nd sess., (1968).

[2]S. 34, 91st Cong., 1st sess., (1969).

[3]S. 296, 91st Cong., 1st sess., (1969).

gross abuse of trust," as stated now in the Act, to "breach of fiduciary duty." A third bill emerged as the final Senate version.[1] This measure embodied features of the previously introduced bills but more closely resembled the Sparkman bill.

In March, 1969, Representative William S. Stuckey introduced a bill in the House which would drastically revise the major provisions of the Sparkman and McIntyre bills.[2] The Stuckey bill was seen as being more tolerable to the mutual fund industry than the Senate passed version; however, no final House action was forthcoming by the end of 1969.

With the convening of the second session of the 91st Congress, in 1970, there was pending before the House the Senate bill, S. 2224, which had passed the Senate on May 27, 1969; an identical version, H.R. 11995, introduced by Representative John Moss, Chairman of the House Subcommittee on Commerce and Finance; and another bill, H.R. 14737, introduced by Representative W. S. Stuckey, which differed considerably from the Senate version. As was the case the year before, the Stuckey bill was the more acceptable to the mutual fund industry but less acceptable from the point-of-view of the orignal intent of the SEC proposals submitted almost four years earlier. The House subcommittee finally yielded and approved a mutual fund regulation bill which

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[1]S. 2224, 91st Cong., 1st sess., (1969).

[2]H.R. 8980, 91st Cong., 1st sess., (1969).

emerged from the committee less industry oriented than the Stuckey proposals, but still considerably different from the Senate passed bill. House approval came late in the year and, following conference committee action, Congress passed the Investment Company Amendments Act of 1970.[1]

Thus, nearly four years after the Public Policy Report recommendations were presented to Congress, the first major amendments were made to the Investment Company Act since its passage in 1940. The Amendments Act of 1970 contained over fifty separate amendments, many of a purely technical nature, but with the following major provisions:

A. Management Fees:

The SEC or a shareholder is given the right to test in court whether the investment advisor to a fund has fulfilled his "fiduciary duty" with respect to the size of the fees the fund must pay for his services.

B. Sales Commissions:

Industry self-regulation is provided for through the National Association of Securities Dealers, an industry self-regulatory body, which is directed to study and establish policy regarding the general level of sales charges.

C. Front-end Loads:

Front-end loaded contractual plans must refund 85 percent of its sales charges if an investor abandoned the plan

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[1]Investment Company Amendments Act of 1970, 84 Stat. 1413 (1970).

within eighteen months. Further, front-end load plans cannot impose more than 64 percent of their sales charges during the first four years, or more than 20 percent during any one year.

C. Performance Fees:

Investment advisor compensation contracts containing sliding scale fees, based on performance, would have to be decreased as well as increased in line with performance relative to certain stock indexes.[1]

Additional analysis of the provisions contained in the Investment Company Amendments Act of 1970 and its relation to the conclusions of the various studies that precedes its passage will be undertaken in subsequent sections. The primary subjective evaluation that may be applied to the act at the present is that the major provisions strengthen the 1940 Act and provide additional investor protection, but certain provisions remain cause for investor concern.

Twentieth Century Fund Study

The Twentieth Century Fund, a non-profit, non-partisan research foundation which undertakes timely, critical and analytical studies of major economic, political and social institutions and issues, sponsored a study of institutional investors and their economic effect on the stock market and securities industry. The study, beginning in 1968, was carried

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[1]*Wall Street Journal*, November 24, 1970, p. 4.

out by the Securities Research Unit of the Wharton School of Finance and Commerce, University of Pennsylvania, with the report being published in 1970.[1] Primarily economically oriented, this study analyzed the implications for the economy as a whole of the increasing importance of institutional investors in the stock market, with particular emphasis on mutual funds.[2] Much of the data presented in the study represents an updating of the Wharton Report; however, the economic impact of mutual funds on the economy is treated in much greater depth.[3] Due to the inaccessability of confidential data from the fund management groups, certain areas receiving analysis in the Wharton Report are not updated in the Twentieth Century Fund Study. These areas of omission are: (1) any analysis of the effect of fund activity on very short-term stock market movements; (2) information on mutual fund control of portfolio companies; and, (3) conflicts of interest between fund shareholders and management.

This study represents a different approach than the

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[1]Irwin Friend, Marshall Blume, and Jean Crockett, Mutual Funds and Other Institutional Investors (New York: McGraw-Hill Book Company, 1970). (Hereinafter referred to as the Twenieth Century Fund Study.)

[2]Ibid., p. IX.

[3]It is significant that the senior researcher for the 1970 Twenieth Century Fund Study was also the senior researcher for the Wharton Report. He is Professor Irwin Friend, Wharton School of Finance and Commerce, University of Pennsylvania; also Director of the Securities Research Unit and Consumer Expenditures Unit at Wharton School.

other studies reported in this chapter. The orientation of the 1970 study is primarily economical while the other studies have represented the regulatory point of view. In addition, the Twenieth Century Fund Study utilizes methods of statistical and other data analysis not available to the researchers before and represents the most sophisticated treatment of statistical data apparent in any of the studies reported herein. The study, in addition to presenting an overview of the institutional investment field and the trends such investment has taken in recent years, has as its major subject areas the following: (1) investment performance of mutual funds; (2) mutual funds and market efficiency; (3) impact of mutual funds on market movements; and, (4) impact of institutional investors on market efficiency. Further, some major policy issues receive brief comment.

The primary conclusions reached by the researchers in the Twenieth Century Fund Study are summarized as follows:

1. Institutional investment: an overview and trends:
   A. Institutional investment has evidenced phenomenal growth over the past several years. This growth has created stress in certain areas, particularly the mutual fund area, but has generally been a favorable factor in the general economy.
   B. Trends over the last two decades in institutional investing have been:
      (1) representing a larger percentage of total capital

market;

(2) toward common stocks and away from government securities as the major portfolio holdings;

(3) toward wider representation of the general investing public; and,

(4) a movement towards emphasis on market value growth and away from earnings yield, at least in the mutual fund section.[1]

2. Investment performance of mutual funds:

A. In general, funds have not matched the performance of the unweighted portfolio of the New York Stock Exchange during the 1960-1969 period. But, they have matched the performance of the weighted portfolio, and the high-risk funds have surpassed it, especially in the 1964-1968 period.

B. Regardless of their market performance, mutual funds have served useful economic functions of: (1) providing diversity for small investors; (2) raising average return for investments of small investors; and (3) their large purchases have helped narrow risk differentials between common stock and other forms of investment.

C. No consistent relationship appears to exist between investment performance and fund size, management ex-

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[1] Twentieth Century Fund Study, pp. 1-49.

pense, portfolio turnover, or sales charges.[1]

3. Mutual funds and market efficiency:

   A. Mutual funds as a whole are neither especially good nor especially bad in directing capital into profitable areas of investment. This holds true for both long-run and short-run timing.

   B. There appears to be a significant amount of follow-the-leader type of investment policy where a number of fund managers follow their more successful colleagues investment behavior.[2]

4. Impact of mutual funds on market movements:

   A. There is no significant evidence that mutual funds have the ability to predict or to influence quarterly or monthly movements in the stock market as a whole.

   B. While the evidence is slim, there is some indication that mutual funds may in their trading of individual issues either anticipate or cause subsequent abnormally large price movements.[3]

5. Impact of institutional investors on market efficiency:

   A. In spite of the greatly increased stock activity by institutional investors, there does not appear to be any noteworthy trend in market efficiency. This is

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[1] *Ibid.*, pp. 22,50-68.

[2] *Ibid.*, pp. 72, 79.

[3] *Ibid.*, pp. 80-90. The price movement issue is considered further in the *Institutional Investor Study*, *infra*.

supported by earlier findings that mutual funds showed neither superior nor inferior ability to direct investment capital into areas which result in the most profitable returns.[1]

The Twentieth Century Fund Study emphasizes the economic effect of institutional investing and has little to say about the regulating issues that are of concern in this research effort. Three areas of policy issues are identified as being worthy of inspection. Those are: (1) Are there undesirable effects associated with the rapid and continuing rate of growth of institutional investment, and, if so, should that growth be controlled? (2) Should certain characteristics of institutional investing in the area of portfolio company policies and trading practices be restricted? and, (3) Are new measures required to provide adequate protection in the areas of conflict of interest between institutional investors and management groups? These issues are relevant to the basic research question of this thesis and the viewpoints projected by the Twentieth Century Fund Study on these issues are considered in the formulation of the conclusions contained in Chapter V.

Institutional Investor Study Report

A Congressional joint resolution of July, 1968 directed the Securities and Exchange Commission to conduct an economic

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[1] Ibid., pp. 91-94.

study of institutional investors and their effects on the securities markets, the interests of the issuers of securities, and the public interest. The results of this study were reported to Congress, in March of 1971, as the Institutional Investor Study Report.[1] The primary areas of concern investigated by the study are: (1) institutions as investment managers; (2) the impacts of institutional investing on securities markets; and, (3) the impacts of institutional investors on corporate issues.[2]

The Institutional Investors Study placed heavy emphasis on the application of quantitative, mathematical techniques to the analysis of economic and regulatory problems. The study covers all types of investor institutions. The major findings of the study that apply to investment companies follow:

A. Investment Managers: Competitive pressure for improved investment performance has spread to investment managers of all types, forcing them to assume higher levels of risk in making their portfolio investments. The SEC believes improved disclosure of investment returns, portfolio activity and short-term trading is needed to better inform holders of such risks. It also believes changes are needed in the system of incentive fees that portfolio managers

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[1] U.S. Congress, House, Institutional Investor Study Report of the Securities and Exchange Commission, H.R. 92-64, 92nd Cong., 1st sess., 1971. (Hereinafter referred to as the Institutional Investor Study.)

[2] Ibid., p. VIII.

receive, suggesting that such systems provide penalties for below-par investment performance that are "symmetrical" with rewards for above-average performance.

B. New Issues: It does not appear that institutions, as a group, are receiving preferential treatment in obtaining shares of desirable new stock issues. Nor has their participation been so limited that there is concern about a scaracity of available capital for newer, smaller enter prises.[1]

C. Market Effect: The study concludes that the growth of institutional trading does not necessitate the imposition of any curbs or limitations on the extent of such trading. In fact, it is suggested that any stock curb could impair the liquidity of the nation's securities markets. In general, institutional trading contributes to relatively few of the large price swings in the stock market and that, as a rule, institutional trading appears to counteract price movements about as often as it appears to contribute to them. Stock market price stability has not been disturbed by institutional trading.[2]

D. Institutional Membership: The report states that the SEC's experience to date has not shown any regulatory problems severe enough to justify "sweeping prohibitions" against

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[1] Wall Street Journal, March 11, 1971, p. 6.

[2] Institutional Investors Study, pp. XXI-XXV.

institutions becoming stock exchange members. But, the commission withheld a final decision on the issue, pending action by the stock exchanges to eliminate fixed minimum rates on portions of stock transactions over $500,000. The SEC has told the New York Stock Exchange to eliminate such rates by April 5, 1971. It is believed that negotiated rates would lower brokerage costs for the institutions and, therefore, discourage them from seeking seats on the exchanges.

E. Improved Institutional Reporting: There are currently "gaps" of information about the purchase, sale and holdings of securities by major classes of institutional investors. These shortcomings should be eliminated through legislation giving the SEC authority to require standardized periodic reports from all types of financial institutions. Once the law is passed, the SEC would consult with other regulatory agencies on the form, frequency and content of the reports and on arrangements whereby different agencies could share the data that is reported. Individual investors would also have access to this data.

F. Market Structure: The Commission does not believe it should try to devise a particular market structure. But, its "objective" is a "strong central market system" that would provide access to all investors, allow all "qualified" broker-dealers to participate and be controlled by "appropriate regulation" and competitive forces. The commission

should try to prevent the evolution of the marketplace from being distorted by "unnecessary restraints" on competition, such as fixed minimum commissions and rules that keep broker-dealers from dealing with each other. Further, the study concludes that geographically separate trading markets are feasible and can be tied together on a national basis through the use of modern communications and data processing techniques.

G. Corporate Takeover: The report suggests that Congress reexamine existing laws and consider prohibiting transactions in which mutual funds and other institutional investors get advance information about a planned take-over in return for aiding it. The recommendation is aimed primarily at cases in which an institutional investor buys stock in a target company on behalf of the acquiring concern, then "parks" it in his portfolio until the acquiring corporation makes a tender offer at an attractive price. The SEC has long been concerned about the role of mutual funds in such take-overs, but it has been uncertain whether existing law is adequate to deal with it. The report contains ten case studies of participation by institutions in takeover transactions. The cases involve instances where, in the SEC's opinion, the institution exerted too much influence in merger activities, where there was an exchange of confidential information between the acquiring companies and an institution, and where several institutions acted

in concert with one another after getting "inside" information about a corporation's take-over plans.[1]

H. Disclosure: The report urges congressional consideration of an amendment to the 1934 Securities Exchange Act that would require institutions to disclose holdings of equity securities that exceed 5 percent (currently 10 percent) of an outstanding securities issue. This would include not only securities that are beneficially owned by an institution but also shares under common investment management. Thus, an investment advisor would report shares held by various investment companies and other accounts it manages if the aggregate holdings exceed the 5 percent level. Also, the study suggests broadening such disclosures even further to require institutions to state more specifically their policies on involvement in corporate affairs. Unless more information is required, the study says, the SEC cannot "intelligently" assess the degree of influence institutions exert over portfolio companies.[2]

The Institutional Investor Study made no legislative recommendations. The study will probably be the basis for additional recommendations to those listed above after the Commission reviews the report further. If additional legislation is deemed necessary, based on the findings of the report, such legislation would be drafted and submitted to the

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[1] Wall Street Journal, March 11, 1971, p. 6.

[2] Wall Street Journal, March 8, 1971, p. 1.

Congress; however, the SEC's rather mild conclusions, based on the study research, would seem to indicate that additional legislation is not imminent.

CHAPTER IV

ANALYSIS OF CURRENT REGULATORY ISSUES

Chapter III identified the issues most commonly associated with mutual fund regulation as presented by the various studies conducted during the prior decade. New legislation was enacted in 1970 to correct some of the issues; however, some areas of investor protection remain subject to additional analysis and possible future regulation. It is the effectiveness of existing regulatory measures and adequacy of protection afforded investors in those areas which are directly related to the actions of the mutual fund management companies that will be the subject of analysis in this Chapter.

Discussion of Current Issues

Recent studies have not revealed any new regulatory issues, but instead have reaffirmed the old issues and updated the research data. The most descriptive listing of regulatory issues is that contained in the Public Policy Report. Therefore, the terminology of that report will be used here as a framework for discussion. Of the six basic issues stemming from the Public Policy Report, only four are directly concerned with mutual fund management companies. Mutual fund size and investment performance is considered a function of investor interest and share purchases, not a result of manage-

ment company actions. The idea that management company sales efforts contribute in large measure to larger size funds is a valid argument, but the issue of fund promotion will be considered in the areas of distribution and its cost. Likewise, the issue of investment company growth and market impact is considered outside the area of the basic research question. Germane to the question of the adequacy of regulation of mutual fund management companies are the following issues:

1. the management function and its cost;
2. portfolio transactions;
3. distribution and its cost; and,
4. relationships with portfolio companies.

Management Function and its Cost

Most mutual funds are managed by external investment advisory organizations which are controlled by the fund's organizers or by their successors. Mutual fund advisory organizations, or management companies as they have been referred to in this report, often manage large pools of capital, but it is not unusual for them to employ relatively few people and require relatively little of their own capital. In addition to investment advice, the investment advisor often furnishes certain administrative services, office space and facilities, and sometimes pays the compensation of the officers and employees of the fund. In return, the fund pays the management company a fee for its services. Stock transfers, dividend disbursing, and custodial services represent the most substan-

tial non-advisory services required by mutual funds, but the cost of these services are usually not paid for by the advisory fee. Investment advisor organizations often provide their services to a group or family of funds.[1] Beyond a certain point, further increases in the mutual fund's assets does not lead to commensurate increases in the costs of furnishing the fund with investment advice and other management services. There are considerable economies of size which result. This situation reflects the fact that management of a small portfolio requires much the same general economic market forecasting, analysis of various industries, and evaluation of individual securities as does the management of a large portfolio. Under the present mode of operation these economies of scale accrue to the benefit of the investment company management group. The Wharton Report found that most investment advisors were not sharing any economies of size with the fund shareholders. In four out of every five cases the mutual fund advisory fee rates were fixed and did not vary with the size of the assets managed.[2] Studies over the last ten years show that

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[1]For example, Investors Diversified Services, Inc., manages six funds having total assets of over $6.3 billion; Keystone Custodian Funds, Inc., manages twelve separate funds with assets of over $1.4 billion; Putman Management Company, Inc., advises nine funds having assets of $1.6 billion; Vance Sanders and Company, Inc., advises seven funds with assets of $3.7 billion; and, Wellington Management Company which manages over $2.3 billion in twelve funds. In April, 1971, there were 21 management companies advising five or more funds. Source: "1971 Mutual Fund Guide," Fundscope, April, 1971.

[2]Wharton Report, p. 480.

management fees have tended to cluster heavily around the traditional rate of 0.50 percent of average net asset value per annum. An examination of fifty of the largest, most popular funds shows that reducing scale formulas have increased in use since 1960; however, they are still the exception rather than the rule. The descriptive situation is still a management fee of one half of one percent per year of average net asset value.[1] Incentive formulas, based on performance in relation to one of the popular market indexes have become more popular. Normally management groups propose incentive formula advisory fee plans only in those cases where past experience has shown favorable market performance. Therefore, these formulas often result in even higher fees being paid for the management functions. Also, management companies advising several funds accrue tremendous economies of scale, yet maintain advisory contracts with all their funds providing for fees at the standard rate.

The management fees paid by mutual funds are considerably higher than those charged for other types of investment management. They are substantially higher than the fee paid banks for the management of pension funds and profit sharing plans. For example, the advisory fee chargeable to a $100 million portfolio under the bank fee schedules for pension and profit sharing plans averaged 0.06 percent in 1965 as compared to the

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[1]"1971 Mutual Fund Guide," Fundscope, April, 1971.

0.50 percent rate commonly charged by mutual funds of comparable size.[1] Also mutual fund management fee rates are substantially higher than those charged registered investment companies which are operated by banks and other institutions as equity investment vehicles. In 1965 the average management fee for such companies was 0.12 percent of average net assets.[2] Mutual fund advisory fee rates also are considerably higher than the rates that private individuals pay for investment advice and management for comparable asset levels. While the basic annual rate is often 0.50 percent this rate is usually halved for portfolios ranging from $1 million to $2 million and can be negotiated even lower for portfolios in excess of $3 million.[3] These fees for individual investors usually also cover services, such as custodial services, not provided mutual funds. While the managerial services required by the various investment medium differ somewhat the Public Policy Report concluded that "these differences do not adequately explain the extent of the disparity between other types of investment management and mutual fund advisory fee rates."[4] It should be noted, however, that several fully litigated cases have failed to prove that the present fees

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[1] Public Policy Report, pp. 11, 114-118.

[2] Ibid., pp. 11, 118-119.

[3] Ibid., pp. 11, 119-121.

[4] Ibid., p. 11.

are unreasonable or excessive. The reasons for the relatively stable, and in the opinion of some excessive, mutual fund management fees are twofold. First there is a lack of competition for management contracts, the shareholders are usually faced with acceptance of the management contract offered by management or the uncertainty of operation without a management contract or investment advisor. Secondly, there has been wide shareholder acceptance of standard fee rates associated with rising markets. The result has been a relatively stable one half of one percent yearly management fee for most mutual funds. This is higher than comparable fees for similar investment advice and management, disregards the economies of scale inherent to the larger funds, and in the end represents an increasingly large cost for the fund to bear at the expense of the shareholders.

Present regulation pertaining to advisory fees consists of two items. Federal securities law requires full disclosure of management compensation in the investment company industry. However, because neither cost considerations nor competitive factors influence a fund's choice of advisor, the restraint of disclosure is less effective on managerial compensation in the mutual fund industry than it is in other industries. The other form present regulation takes in relation to management fees is the requirement that both stockholders and unaffiliated directors approve advisory contracts. This provision has rarely operated to provide fund shareholders with an adequate

share of the economies of size. Because of the absence of competition, the limitations of disclosure, the ineffectiveness of shareholder voting rights, and the difficulty of effective action by unaffiliated directors advisory fee rates have not declined as funds grew in size. Only as a result of the pressures generated by the <u>Wharton Report</u> coupled with the pendency of shareholder litigation have such departures as there have been occurred from the traditional flat fee of one half of one percent. These departures have been few and seldom very substantial.

The <u>Public Policy Report</u> recommended and the SEC subsequently submitted legislation providing for a "standard of reasonableness which would be enforceable in the courts" with regard to management fees.[1] The proposal that the courts could be asked to pass judgment on the reasonableness of management fees was attacked by opponents within the mutual fund industry as a true rate-making statute that would place the SEC in the position to control management fees. The proposal was also condemned on the grounds that it would open up a plethora of shareholder lawsuits that would seriously interfere with management's duties. The eventual legislation that became law was the Investment Company Amendments Act of 1970 which provided either the SEC or the individual shareholder the right to test in court whether the investment advisor to a fund has fulfilled his fiduciary duty with respect to the size of the fees a fund

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[1]S. 2224 91st Cong., 1st sess., (1969).

must pay for the advisory services. Insufficient time has elapsed following the implementations of this provision for any court tests to be completed.

The Institutional Investment Study Report, submitted subsequent to the enactment of the Investment Company Amendments Act but in preparation concurrently with the consideration of the legislation, recommended that certain changes are needed in the system of incentive fees that some fund managers receive. Specifically, the study suggested that such systems provide for penalties for below par investment performance that would be symmetrical with rewards for above average performance.[1] Ironically, the 1970 Amendments Act contained a provision requiring that investment advisor compensation contracts contain sliding scale fees based on performance would have to be decreased as well as increased in line with performance relative to certain stock indexes.

Research conducted over the past decade and reported in connection with a major study of the industry indicates that the existing regulatory provisions which apply to the subject of management advisory fees have proven inadequate in providing mutual fund shareholders the degree of reasonable protection they could logically expect.[2] The three factors of acknowledged economies of size, unchanging man-

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[1] Institutional Investors Study, p. XIV.

[2] Public Policy Report, p. 12-13.

agement fees, and the continued concern and interest about the issue on the part of the industry, SEC, and Congress that resulted in an amendment to the law strengthening the regulatory statutes in relation to advisory fees seems to conclusively prove the inadequacy of the existing provisions. How adequate the new provision enacted with the 1970 Amendments Act will prove to be must await a reasonable test of time.

The measure of effectiveness of management fee regulatory provisions is difficult. While the existing statutes were inadequate and failed to effectively protect the interests of the shareholders regarding advisory fees, the case could also be argued that the laws were effective in that disclosure was accomplished and both shareholder and unaffiliated directors do approve advisory contracts. Therefore, the existing regulations were effective, they accomplished what they were supposed to do but were inadequate to accomplish the intended task of adequate shareholder protection. The effectiveness of the new "fiduciary duty" provisions of the Investment Company Amendments Act of 1970 cannot be determined until after a sufficient period of time has passed to allow litigation to be completed.

With respect to the issue of management fees, it is recommended that the provisions of the 1970 Investment Company Amendments Act be given a reasonable time trial. If those efforts are insufficient to cause some significant changes to occur that insures some measures of the economies of size being

returned to the shareholders in the form of reduced or sliding scale advisory fees, then legislation should be extended to accomplish this change. Any legislation which might eventually be required should avoid rate making powers to the extent possible, but should arrange a standard of reasonableness that would be workable in the industry. The voluntary, or if necessary, the forced adoption by the industry of a reducing scale management fee with incentive, both of the reward and penalty type, based on performance is accomplishing the fund's investment objective is considered the optimum solution to the issue of the management function and its cost. Adoption of those measures would result in the shareholders receiving some measure of the economies of size as well as the management advisors being properly rewarded or penalized for their performance.

Portfolio Transactions

The large number of portfolio transactions and the substantial amount of brokerage costs these transactions generate have become an increasingly important source of revenue to the securities industry. For example, in 1965 these charges amounted to over $100 million for the mutual fund sector alone.[1] The large volume of portfolio transactions and the resulting large amounts of brokerage are the result of two factors. First,

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[1] Public Policy Report, p. 155 (original source was the Investment Company Institute).

the growth which has taken place in both the size and number of mutual funds over the past twenty years accounts for a large measure of the volume.[1] Secondly, the rise of the performance managers who are often characterized by their rapid portfolio turnover practices in quest of above average fund performance has also contributed to the large volume of mutual fund portfolio transactions. The result of those two factors has been an extremely large volume of brokerage business generated by the mutual fund industry. This large increase has generated its share of problems along with its large dollar volume of commissions. The major problem areas are: (1) allocation of brokerage, (2) the problem of reciprocals and give-ups; (3) broker affiliated funds; (4) exchange membership for funds; and, (5) negotiated commissions.

Portfolio holdings of investment companies tend to be heavily concentrated in securities listed on the New York Stock Exchange. While some mutual fund transactions are executed on regional exchanges and in the over-the-counter market, the vast majority of the fund transactions are executed on the New York Stock Exchange.[2] Charges for the execution of transactions in the over-the-counter market are subject to negotiation; however, on the other exchanges, brokerage commissions are governed by exchange minimum commission rate schedules. This means

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[1]See Chapter II, supra for discussion concerning growth of mutual funds.

[2]Public Policy Report, pp. 15, 157.

that the commission on a 10,000 share order is 100 times that commission for a 100 share order. This situation presents a very lucrative operation on large orders and consequently brokers compete vigorously among themselves for investment company patronage. One study found that on the NYSE the average cost of handling a 1,000 share, a 10,000 share, and a 100,000 share order of a $40 stock was, respectively, 6, 42, and 377 times the 100 share commission.[1] Since a large portion of investment company portfolio transactions involve a large block of shares, the brokerage business of mutual funds is eagerly sought after and represents a large contribution to the profitability of the securities industry.

Because of the profitability involved in conducting mutual fund trades, exchange members are often willing to execute and clear transactions for mutual funds for a fraction of the commissions they must charge them. They allow mutual fund managers to allocate a substantial portion of the brokerage to other brokers who had nothing to do with the execution of the transaction on which the brokerage was earned. Some of this brokerage is allocated to broker-dealers for non-sales services such as investment research, investment recommendations, communications facilities, pricing services, and others. This practice is to the benefit of the shareholders. However, many managers, prior to the practice being prohibited at the

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[1] Institutional Investor Study, p. 102.

end of 1968, used a substantial portion (60 to 70 percent) of the funds brokerage to pay dealers extra compensation for sales of fund shares. This practice known as the "customer directed give-up," so called because the fund manager directed the broker who executes the order to give-up portions of that commission to one or more designated brokers who have no connection with the transaction, was not in the best interest of the fund shareholder. Generally the individual shareholder does not benefit from additional sales of fund shares, but the management company stands to benefit from a larger fund through receiving larger fees. However, the brokerage generated by a fund transaction is a fund asset and should be used for the benefit of the fund shareholders, not the management advisory company. Thus, the temptation to allocate brokerage and give-ups to generate sales at the expense of using the same funds to pay for investment information or other non-sales services is an area requiring attention by those responsible for protecting the best interests of the fund shareholders.

The impact of give-up and reciprocal practices in the mutual fund industry was great. Reciprocity is an accepted custom of the business world; however, it had a unique character in the mutual fund industry. As noted above, the use of brokerage commissions as extra compensation to retailers of fund shares primarily benefits the fund advisor-underwriter rather than the fund and its shareholders. The fund and its

shareholders could derive greater benefits from their brokerage if give-ups were transferred to the fund for the purpose of offsetting management costs or other expenses. The use of brokerage for sales compensation perpetuates the potential for harmful practices on the part of management companies. The temptation to skimp on allocation of brokerage for investment advice in favor of accelerated sales; the pressures for churning of the fund portfolio to generate brokerage commissions; the danger that reciprocal and give-up practices may impair the integrity of dealer recommendations; the hidden influences which perspective brokerage give-ups might have on dealers activities; and the anti-competitive efforts between funds of different sizes are all factors which mitigated against the reciprocal and give-up practices employed by the mutual fund industry.

Modification of the above conditions resulted from the rate changes adopted by the NYSE on December 5, 1968. On that date the exchange adopted an interim commission rate schedule which incorporated a volume discount and prohibited customer directed give-ups. The ASE and regional exchanges adopted similar rules. The volume discount reduced the commissions on orders over 1,000 shares on securities selling for less than $90 per share and fixed the commissions on a single order to not exceed $100,000. The impact of this rate structure was to spread the brokerage business of mutual funds among a larger number of broker-dealers. However, the same

pressures noted above still contributed to the brokerage allocation decisions of fund managers. While the practice of give-ups was curtailed the placing of a transaction order is still often based on factors other than who can execute the order the most economically and efficiently for the benefit of the fund.

Another problem in the area of portfolio transactions is the broker-affiliated investment company. Close affiliations between a mutual fund and broker-dealers who execute their portfolio transactions raise questions similar to those raised concerning the use of brokerage commissions to compensate the dealers for sale of fund shares. Under the broker-affiliated situation the brokerage which was used as a give-up now stays with the brokerage firm that is managing the fund. Again this is a profitable situation for the broker-dealer, but not always in the best interest of the fund or its shareholders. One positive viewpoint concerning broker-affiliated funds is that a small fund is able to benefit from resources of a sponsoring brokerage firm that the fund might find beyond their means were they independent. Also, a broker-affiliated fund benefits from lower transaction rates if, as often is the case, their brokerage firm-manager is a member of the NYSE. This introduces the issue of exchange membership for institutional investment firms which will be analyzed below. To summarize the issue of broker-affiliated mutual funds the situation is not widespread, nor the most important

regulatory issue of the day, but does present a situation where the best interests of the fund shareholders could be easily abused and is a situation possibly requiring regulation.

The subject of institutional investor exchange membership has already been introduced and represents a very current issue in the area of mutual fund portfolio transactions. Because of the fixed fee commission rate on the NYSE and with the curtailment of the give-ups in 1968, the fund managers, especially of the larger funds, have considered the possibility of buying seats on the NYSE in order to benefit from the favorable member trading rates which are considerably lower than the rates charged nonmembers. While several regional exchanges have allowed institutional membership, the NYSE and the ASE have maintained rules prohibiting mutual funds and other publicly held firms from membership. Recently the NYSE amended its rules to allow publicly held brokerage firms to become members. Two large mutual funds also applied for membership and the question was taken under consideration. Currently there is a detailed study being conducted which will, it is expected, clarify the exchange's position concerning institutional membership. The potential benefits for a large investment company are enormous and should the exchange rules be modified to allow institutional membership it would be in the best interest of the fund's shareholders. Some powerful members of the securities industry are strongly opposed to the

idea, and consequently, it may be some time before this issue is resolved. Others in the industry feel that negotiated rates on large block trades is the better alternative. This subject will be analyzed next.

The subject of negotiated commissions on large stock trades has very recently been to the forefront of the portfolio transaction issue. Although the NYSE adopted a volume discount commission rate schedule late in 1968, that rate schedule still retains fixed rates on large transactions. The mutual funds who are the largest customers in the block trade market have long opted for some way to reduce the total commissions on large transactions. As noted earlier, most broker-dealers were very willing to give-up portions of their commissions on block trades prior to this practice being prohibited in 1968. Most large firms were giving up as much as 60 to 70 percent of their commissions because of the profitability of the investment company brokerage business. With the prohibition of give-ups, the fund managers needed to find other ways to compensate dealers for fund sales and become more interested in effecting portfolio trades in the most economical and efficient way. With exchange membership denied them, the most logical way to reduce commission costs was by negotiating rates for large transactions. But the NYSE fixed rate system prohibited negotiated rates and the brokerage houses were unreceptive to the idea because they feared the resultant loss of income. However, the SEC had long held that

commission rates for large block trading were too high, so directed the NYSE to shift to negotiated commissions on all transactions exceeding $500,000.[1] This proposal was contained in the Institutional Investors Study but had been considered as far back as the Special Study. The negotiated rate system went into practice on April 5, 1971 and it is expected to noticeably reduce the brokerage rates of mutual funds. Many people in the industry expect the negotiated rate system to significantly lower the cost of brokerage for the funds so that exchange membership will not seem as attractive or desirable, thus removing that thorny issue from the forefront of concern.

Present regulation of investment company portfolio transactions consists primarily of the rules covering exchange trading along with state regulations and industry self-regulatory rules of the NASD and the Investment Company Institute. Existing regulations proved ineffective in preventing the development and abuses of the reciprocity and give-up practice. While the give-up prohibition of 1968 has for the most part eliminated that situation many factors still exist that tempt investment company managers to use brokerage for purposes other than in the best interests of the shareholders. It is

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[1]Actually the standard commission rate applies on the first $500,000 of any transaction with the commission rate on all of the transaction exceeding $500,000 subject to negotiation between the customer and the broker. If the system works as planned, it is expected that the SEC will lower the $500,000 figure sometime in the future.

easily understood why fund managers are reluctant to voluntarily abandon or refrain from engaging in practices that favor accelerated sales of fund shares or to withstand pressures for churning of the fund portfolio. A larger fund means greater management fees, and greater portfolio turnover generates more brokerage commissions, both measures of success for the management company if the loyalty of the manager is directed toward the profitability of the management company at the expense of serving the best interests of the fund shareholders. The SEC is attempting to correct the problems in the area of portfolio transactions by changing exchange trading rules and has not requested additional legislation. Because of the nature of the problems involved with this issue, the SEC approach is probably the best alternative. The speed at which the SEC has proceeded in this matter leaves much to be desired, but their approach is basically sound. Adequate legislation exists for the control of exchange operations and trading practices. The securities industry has repeatedly expressed the willingness to exercise additional self-regulation to avoid additional legislative regulation. It remains for the industry to adequately self-regulate itself and the SEC to adequately and effectively protect investment company shareholders from the abuses and unfavorable actions of the fund management companies in the area of portfolio transactions.

Distribution and Its Cost

The sales of new fund shares on a continuing basis has accounted for a large segment of the growth of the mutual fund industry. The relatively low price per share, the promise of professional management, and the ready availability and ease of purchase of mutual fund shares made available to the small investor, often for the first time, an opportunity to participate in the stock market. Some new sales are necessary to offset redemptions; however, the sale of new shares far exceeds the redemption rate as evidenced by the growth of the industry during the past twenty years.[1] The cost of the distribution of these new shares is the issue for analysis here.

The distribution of a fund's shares is accomplished through an underwriter, often a wholly-owned subsidiary or closely associated group of the management advisory company. The underwriter sells the shares to a dealer who in turn, through salesmen, sells the shares to the individual investor. The cost of this operation is offset by assessing the customer a sales charge for each share similar to the per share commission associated with a security transaction accomplished by a broker. This charge, known as a "sales load," is the difference between the current net asset value per share received by the fund and the public offering price paid by the investor. This basic load typically amounts to 8.5

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[1]See Chapter II, supra, for discussion of mutual fund growth.

percent of the offering price per share and is by far the most significant charge paid by mutual fund investors.[1] It is the level of the sales load that is the major subject of this discussion.

A second major problem in the area of distribution and its cost is the area of front-end load contractual plans. A contractual plan is one which allows the planholder to accumulate shares of a mutual fund on an installment basis. A sales load of up to 50 percent is deducted from the first year's payments and is known as the "front-end load." A typical contractual plan calls for investing $3000 by making $25 payments monthly for 10 years. The total sales load on the complete plan cannot exceed 9 percent; thus, with 50 percent coming out the first year, subsequent years are reduced. The front-end load feature of contractual plans results in about six times the sales compensation for the first year as compared to the sales load on a voluntary or lump sum investment in the same mutual fund. This high sales charge works to the disadvantage of the planholder, will result in the planholder always having less percentage of his investment working for him, and is particularly disadvantageous to those who redeem or stop making payments before completing their plans. Front-end load

[1]It should be noted that some funds, known as no-load funds, do not charge sales loads of the magnitude indicated here, therefore, the discussion herein is directed not at them, but at that majority segment of the industry which does charge sales loads because there is where the problem exists.

plans are popular with securities sales personnel and sometimes result in high pressure selling practices. Studies show that most contractual plans are not completed on schedule.[1] All factors considered, the best interests of the investor can never be served by purchasing a front-end load contractual plan. Front-end load contractual plans represent the second problem to be discussed concerning the issue of distribution and its cost.

Sales load levels, as noted above, usually represent 8.5 percent of the offering price per share. Sales loads are reduced for large purchases, but those reductions benefit relatively few investors because they are seldom available for purchases of less than $10,000 and many do not apply to purchases of less than $25,000. The sales load pays for selling effort only. The underwriter usually retains from 0.5 percent to 2.5 percent of the offering price, the medium being 2 percent, with the balance of the load going to the dealer. The typical dealer-salesman split is 50-50. The average sales load on mutual fund transactions is significantly greater than the round trip sales charges on individual securities purchased and sold through a broker on a major exchange.[2] They are also higher than OTC sales charges.[3] For example,

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[1] Public Policy Report, p. 22.

[2] Ibid., pp. 20, 210.

[3] Ibid., pp. 20, 212.

a round lot transaction of a $40 stock would result in the following commission charge: $4000 times a commission rate of 1 percent equals $40, plus a surcharge of $15 making a total brokerage charge of $55 for execution of the order. In order to properly equate these charges to those charged mutual fund investors one must consider the total round trip cost because mutual fund shareholders pay only one sales charge, at time of purchase, and do not pay an additional charge for redeeming fund shares. Therefore, the total cost of executing a round trip transaction in the above example would equal $110. This round trip cost is compared to the $340 load charged the mutual fund purchaser on a $4000 investment in a fund charging the normal 8.5 percent load. This round trip sales load for a $4000 transaction is 210 percent greater for the typical mutual fund investor than the cost of a similar transaction of a listed security traded through the services of a broker. Mutual fund sales loads are even higher than the spreads underwriters receive in connection with most underwriter distributions of non-fund securities where, unlike mutual fund underwriters, they assume the risk and make special distribution efforts.[1] In addition, many funds charge shareholders a sales load on shares purchased with dividend income. Many shareholders use the dividends and capital gains distributed by the fund to acquire additional shares through automatic reinvest-

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[1] _Ibid._, pp. 20, 212-214.

ment plans. While a sales load is not charged on reinvestment of capital gain distributions, a substantial minority of funds impose standard sales loads on the reinvestment of ordinary dividends. Sales loads on invested dividends are not related in any way to any special selling effort apart from that involved in the initial sale and are completely unjustified.

Present regulation of sales load levels is limited to the requirement for sales loads to be disclosed in the fund prospectus. Except for contractual plans, no expressed statutory limits are placed on sales loads although the SEC and the NASD are given rule making authority to prevent "unconscionable or grossly excessive" sales loads. At the time of the passage of the 1940 Investment Company Act it was hoped that competition would keep sales loads down. This has not proved to be the case. In fact, the framework of Section 22(d) of the Act, the so-called price maintenance provision prohibiting dealers from selling a redeemable investment security to the public except at a current offering price described in the prospectus, has suppressed any downward pressures that normal market forces might otherwise exert on sales load levels. Senator McIntyre at one time introduced a bill calling for, among other things, the repeal of this price maintenance provision in an attempt to pave the way for lower sales loads, but the provision was not retained in the final Senate bill as passed.[1] The Wharton Report warned of a pos-

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[1]See Chapter III, *supra*.

sible conflict of interest situation between shareholders and management in the selling of fund shares.[1] The Public Policy Report while noting that some disparity between mutual fund sales loads and the cost of investing in listed securities may be warranted considered the existing disparity unjustified. It recommended to Congress that a 5 percent ceiling be placed on mutual fund sales charges as well as prohibiting anomalous and inequitable sales charges such as loads now imposed on the reinvestment of dividends.[2] Considerable opposition was expressed on the part of the industry based on the fear that a reduction in the sales load would result in reduced sales efforts, therefore, less growth in number of shares sold and a consequent reduction or leveling off of revenues flowing into the management advisors. The final resolution of this discussion as evidenced by the Investment Company Amendments Act of 1970 provided for the industry to regulate itself on the matter of sales charges. The NASD is directed to study the situation and establish policy regarding the general level of sales charges. While the NASD has not yet had time to complete any study since the enactment of the law, there exist grave doubts concerning any lowering of sales charges to result from this action. It is interesting to note that neither of the two most recent studies

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[1] Wharton Report, p. 29.

[2] Public Policy Report, p. 21.

in the field of investment company regulation, the Twentieth Century Fund Study and the Institutional Investor Study, addressed the question of the cost of distribution.

The matter of front-end load contractual plans has faired better from the standpoint of investor interests as a result of the Investment Company Amendments Act of 1970. Historically the sales load from the scheduled first year's payments on a contractual plan have been about 50 percent or six times the sales compensation on the same amount invested in the same fund by a lump sum or voluntary plan where the standard sales load of 8.5 percent would apply. This high sales load works to the disadvantage of all contractual planholders including those who complete their plans on schedule because they always have a smaller proportion of their payments working for them than if a level sales load had been deducted from each payment. The front-end load is especially disadvantageous to those who redeem before completing their payments or those who simply stop making payments because they have paid effective sales loads which are many times the normal sales load on the number of shares their investment actually represents. Because of the lucrative commission structure, the front-end contractual plan has proven very popular with mutual fund salesmen, so popular in fact that the incentives have been responsible for undesirable high pressure selling practices. The argument that front-end load contractual plans are an effective stimulus to systematic

investment has been reduced by the plan sponsors' own statistics which show that most contractual plans are not completed on schedule.[1] Because of the basic impacts of the front-end load, the Public Policy Report recommended their future sales be prohibited. The Congress was reluctant to enact a measure this drastic, however, did pass measures that greatly enhance the position of the individual investor in a contractual plan. The 1970 Investment Company Amendments Act provides that front-end loaded contractual plans must refund 85 percent of its sales charges if an investor abandoned the plan within 18 months. Further, front-end load plans cannot impose more than 64 percent of their sales charges during the first four years, or more than 20 percent during any one year. These measures will tend to level out the sales load on contractual plans as well as insure the investor recovery of 85 percent of his sales load as well as his shares should they be liquidated within 18 months. While this provision of the law is not popular with those industry representatives connected with the front-end load plan, it certainly is a welcome step toward the type of regulation necessary to provide the investor the type of protection he can reasonably expect.

The adequacy and effectiveness of regulatory statutes applying to the issue of mutual fund share distribution and

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[1]A study conducted in 1962 by the Securities Research Unit of the Wharton School of Finance and Commerce of the University of Pennsylvania for the Special Study confirmed the same findings.

its cost before the passage of the Investment Company Amendment Act of 1970 was clearly questionable. Sales loads have remained significantly above the round trip cost of trading listed securities and front-end loaded contractual plans were unfairly administered from the viewpoint of investor interests. The need for action was apparent. The SEC recommendations of a 5 percent limit on sales loads and the abolishment of front-end load contractual plans were in the best interests of the investing public. These measures were bitterly opposed by the investment company industry, and with sufficient reason from their point of view. The level of interest on the part of the mutual fund management groups in protecting the interests of their shareholders as compared to their own financial interests has never been very high and in this case, the management representatives were attempting to protect their own sources of revenue at the expense and against the best interests of the fund shareholders. The resulting Congressional action represents a compromise that will have to be given a test of time before its effectiveness and adequacy will be known. Self-regulation in the case of sales load levels could work if enough pressure to make it work is forthcoming from the SEC. The securities industry has a generally respectable record of self-regulation when they have been forced to self-regulate or accept additional statute regulation. The new measures relating to front-end load contractual plans should improve the situation materially, reduce the sales effort directed at front-end load plans, and hopefully help

educate the public as to the folly of buying that type of investment plan. Should the mutual fund industry fail to effect some type of self-regulation that results in some lowering of the sales load level, legislative action fixing an upper level equitable to both the industry and the investor would seem to best serve the interests of the investor. The best interests of the investing public concerning front-end loaded contractual plans are best dealt with as the Public Policy Report recommended--abolishment.

Relationships with Portfolio Companies

The relationship between an investment company and its portfolio companies has been an issue of concern since the passage of the 1940 Investment Company Act. In fact, the 1940 Act expresses concern over investment company impact "on concentration of control of wealth and industry and on companies in which investment companies are interested." With the rapid and expansive growth of investment companies during the intervening years the concern has lingered. Of the issues analyzed in this research effort this matter of relationship with portfolio companies seems to warrant the least concern from the standpoint of shareholder protection.

The basic problems involved in the issue is the concern by Congress and others that investment company managements could gain substantial or even dominant positions in other enterprises by investing the fund's assets in the securities of that enterprise. The result could be the exercise of manage-

ment for purposes other than the best interests of the shareholders although the opposite could also result. Studies show that no misuse of power in this regard can be documented to date. The mutual funds have done a good job of self-regulation in this area. The Wharton Report found that mutual fund managers participated in portfolio company affairs only in limited ways and concluded that mutual fund influences on portfolio companies did not warrant serious concern.[1] The Public Policy Report, based on the data in the Wharton Report, suggested that there was no present need for new legislation on investment company--portfolio relationships.[2] However, mutual funds are much larger today than they were during the period of these reports. The Institutional Investor Study examined this issue in some detail and concluded the following:

a) Investment companies and other institutional investors have the potential economic power to influence many companies, particularly large companies, because of their stock holdings. In fact, the concentration of holdings is pronounced in some of the larger companies.

b) Some institutions have personal and business relationships with portfolio companies. These relationships tend to promote conflict of interest situations, however, there is little or no evidence indicating mutual fund management has engaged in this practice.

c) Institutions do not generally involve themselves directly in corporate decision making. The general practice is liquidation of holdings where corporate policies and proposals appear inappropriate. Investment managers generally vote in favor of portfolio company

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[1]Wharton Report, pp. 424-427.

[2]Public Policy Report, p. 28.

management proposals or refrain from participation completely.

d) Some institutions have been actively and significantly involved in facilitating contested transfers of corporate control.[1]

It is the last conclusion that generated the recommendation of the study concerning corporate takeover and the change in the disclosure rules requiring institutions to report all holdings in companies that exceed 5 percent as compared to the present 10 percent.[2]

Present regulation in the field of relationships with portfolio companies is relatively sparse as compared to the other issues discussed herein. The provision for reporting holdings in portfolio companies over 10 percent mentioned above along with general trading and disclosure rules represent the total existing regulation concerning the issue. From the findings of the Wharton Report in 1960, to those of the Institutional Investor Study of 1970, the problems in the area seem minimal. Self-regulation seems to have been effective in this situation and the rather meager federal regulation would appear to have been both adequate and effective from a shareholder viewpoint. Unless significant developments occur in the matter of investment company relationships with portfolio companies, no apparent need is evident that would require any

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[1] Institutional Investor Study, p. 127.

[2] See Institutional Investor Study Report Summary in Chapter III, supra.

further action on the part of the government. The problems of shareholder relations with mutual fund managements appears much more in need of attention than does the area of investment company relations with portfolio companies.

CHAPTER V

CONCLUSIONS

This research project has analyzed the problems associated with regulation of mutual fund management companies. Ancillary to the basic question under examination has been identification of the problems, a review of past research, and examination of the existing regulatory pattern. In summarizing the research conducted in connection with this effort, three subjects surface. First, have the research questions posed in Chapter I been answered? Second, what conclusions can be drawn from the research findings? Third, what areas appear as candidates for further study? The purpose of this Chapter is to provide answers to these three questions as they pertain to the subject of regulation of mutual fund management companies.

The basic research question of this study was, "Is present Federal regulation of mutual fund management companies adequate for investor protection?" The answer is no. On balance, the mutual fund industry is well regulated and provides the mutual fund investor a large measure of protection from gross mismanagement on the part of fund management advisors. However, there are certain problem areas where conflict of interest situations between shareholders and management have developed which should be eliminated by further regulatory mea-

sures in order to insure the shareholder the degree of protection he should logically expect. These areas are: (1) management and its cost; (2) portfolio transactions and the allocation of fund brokerage; and (3) distribution of fund shares and the associated costs.

Five subsidiary research questions were proposed along with the basic question. These subsidiary questions concerned: (1) the history of investment company regulation; (2) identification of the issues of mutual fund regulation; (3) the effectiveness of existing regulation; (4) the adequacy of investor protection provided by existing regulation; and, (5) the need for additional regulation. Have these questions been answered in this research report? It is suggested that the history of open-ended investment company regulation is adequately described in Chapter II. Likewise, the question of issue identification is the content of Chapter III, where identification of investment company regulatory issues was accomplished through the technique of reviewing research efforts conducted over the past ten years. The related questions of regulation effectiveness and the adequacy of investor protection provided by existing regulatory legislation are discussed in Chapter IV as they apply to the particular issues being analyzed. The final subsidiary question concerning the need for additional regulation will be addressed in the affirmative later in this Chapter. With the discussion on additional regulation contained in Chapter V, it is submitted that

all the subsidiary questions, along with the primary research question, have been answered.

Summary

The passage of the Investment Company Act of 1940 provided significant protection to investors who placed their investment monies with mutual funds. The investment company industry is the most thoroughly regulated segment of the securities industry. However, mutual funds have experienced rapid growth since 1940, greater by far than any of the other financial intermediaries, and this growth has created regulatory problems not fully envisioned either during the development of the vast body of securities industry regulation statutes or at the inception of the 1940 legislation. Five major studies relating to investment company regulations have occurred within the past ten years. The same set of issues developed in the first two of these studies prevail as the major issues of concern today with regard to investment company regulation. While mutual funds allow modest investors to own a share of American capitalism evidence indicates they are overpaying for it via excessive sales charges. Further, the investor's cost is not limited to sales loads because most funds pay additional management or advisory fees to an outside advisor for investment advice and management services. These management fees are generally higher than those charged other investment clients and they often become excessive as the fund grows while the fee remains fixed at a flat rate. Serious

conflict of interest situations between shareholders and management also have surfaced in the area of portfolio transactions and the allocation of brokerage. Less serious problems exist in the area of relationships with portfolio companies. Recent legislation, the first major amendments to the 1940 Investment Company Act since its passage, was a compromise between that recommended by the SEC and that acceptable to the industry with the probable effect of being too mild to accomplish the desired results of providing adequate investor protection.

The following specific points are summarized from the data contained in previous chapters and related to the mutual fund industry and its regulation:

1. Industry growth: The mutual fund industry has experienced large growth during the past thirty years in asset value, number of shareholders, and number of new funds.

2. Regulatory legislation: Following the depression years, there developed a vast body of securities industry regulation at the Federal level. This body of regulation has, on balance, proved effective.

3. Investment Company Act of 1940: This statute regulating the investment company industry is the most detailed and thorough component of the Federal body of securities regulation. The 1940 Act has provided significant protection to the investing public whose funds are in mutual funds, but did not adequately deal with certain of the problems which developed

as a result of the vast growth of the industry.

4. Investment Company Amendments Act of 1970: This Act corrects many inequities, but several provisions are cause for investor concern. While a reasonable time should be granted for observation before a final evaluation, it seems questionable that self-regulation in the case of sales loads and the difficult burden of proof requirement connected with the management fees question will result in lower sales loads or management fees. The front-end load contractual plan may die a natural death from lack of salesforce interest, but if that fails to occur, the plans should be abolished.

Conclusions

The following conclusions are drawn concerning the major issues of mutual fund regulation:

1. Management and its cost: Management fees paid by mutual funds to their investment advisors should be reduced to a level comparable to other forms of investment management. No adequate explanation is evident to explain the significant disparity between fees paid by other investment organizations for investment management and the much higher rates paid by mutual funds for like services on portfolios of comparable size. Adoption of a reducing scale management fee rate based on size of portfolio with incentives, both of the reward and penalty type, based on management's performance in accomplishing the fund's investment objective is recommended as the optimum solution to the issue of the cost of management. The

provisions of the Investment Company Amendment Act of 1970 have not yet been given a reasonable trial of time, but it seems doubtful that their mild nature will result in moving management advisors toward returning any significant measure of the economies of size to the shareholders. Voluntarily reducing the income flow is not normal practice in any business and probably could not reasonably be expected of mutual fund management advisors. Therefore, it is suggested that additional legislation will be required to force adjustment in the area of management costs in the mutual fund industry.

2. Portfolio Transactions: Allocation of the brokerage generated by fund portfolio transactions in a fashion that is most beneficial to the fund and its shareholders should be a legal requirement of fund management. Present regulation allows practices to occur that mitigate against the best interests of the shareholders, but accure to the profit motives of the investment advisor. An example is when the brokerage allocation decision is motivated by a desire on the part of the fund manager to reward a firm for sales of fund shares rather than being based on who can execute the transaction most economically and efficiently. A legal requirement binding the fund advisor to place the best interests of the fund and its shareholders foremost in decisions regarding brokerage allocation would largely reduce the temptations which presently cause fund managers to act otherwise. This area is a perfect situation for industry self-regulation, but as was the case

with regards to management fee reduction the magnitude of the revenues involved make self-regulation an unlikely solution. The effect of the new negotiated commission rate system which began operating in April, 1971 on the issue of portfolio transactions cannot yet be properly evaluated. Exchange membership for the funds, should such membership be authorized, would be in the best interests of the funds and their shareholders. Exchange membership may prove practical for only the largest investment companies, however, due to the cost of exchange seats. The lower member trading rates would undoubtedly reduce the cost of brokerage transactions for the funds who were members. Whether or not the savings in brokerage costs, resulting from becoming members of the major exchanges would be significantly lower than the brokerage costs experienced under the new negotiated rate system is a question yet to be answered.

3. Distribution and its cost: The sales loads charged investors in mutual funds should be reduced to a level more in line with the cost of round trip trades of listed securities. The sales load charged mutual fund purchasers, typically 8.5 percent, is significantly greater than the round trip sales charges on individual securities traded through a broker on a major exchange, are higher than OTC sales charges, and are even higher than the spreads received by underwriters in the distribution of non-fund securities. The sales load charged mutual fund investors pays for selling effort only.

It does not benefit the shareholders, but does benefit the underwriters and distributors of the fund shares. While some disparity between mutual fund sales loads and the cost of other types of security transactions may be warranted, the existing disparity is not justified. Having concluded likewise Congress in the Investment Company Amendment Act of 1970 enacted provisions for the mutual fund industry to regulate itself on the matter of sales charges. The NASD is presently conducting a detailed study of the matter and is charged with establishing policy with regard to the general level of sales charges. While this approach should be given every chance to succeed it remains doubtful that lower sales charges will result from voluntary action. Fears on the part of mutual fund managers that any lowering of sales charges will result in reduced sales effort with the consequent reduction or leveling off of management fee revenues flowing into the management advisors are likely to override other considerations. Any reduction in mutual fund sales loads that moves the charges more in line with the cost of executing other types of security transactions will probably require legislation of a stronger nature than that contained in the 1970 Amendment Act.

4. Relationships with Portfolio Companies: This issue has been of concern to Congress and the SEC since the inception of the 1940 Act. The issue seems to attract more attention and concern than it warrants. Evidence to date has not indicated any serious regulatory problems exist in the area of

investment company relationships with the management and policies of portfolio companies. The common practice is for investment companies to liquidate their positions in any portfolio companies where management policy became questionable. Unless additional data is presented which indicates action is desirable there appears no need for regulatory action in this area.

5. Conflict of Interest Situations: There are several areas where potential conflict of interest situations exist between the fund shareholders and the fund management advisor. In addition to those areas discussed herein there are also issues of excessive portfolio turnover, compensation of unaffiliated management personnel, insider trading, and a whole plethora of issues regarding performance. The complete subject of shareholder-management relationships needs extensive review, examination, and analysis.

The answer to the final subsidiary question becomes apparent from the conclusions above. Additional regulation is needed in the areas of management and its cost, portfolio transactions, and the distribution area and its cost. Additional regulation applying to the groups who manage mutual funds is required in order to provide adequate and effective protection to the shareholders against gross mismanagement.

As is common with any research project, areas are touched upon that warrant additional study. Such is the case here. The final conclusion discussed above reflects the problem of

conflicts of interest between shareholders and management groups. A complete study is needed in the area with a view toward recommending legislation that would clarify the responsibilities of each party as well as guarantee the shareholders adequate protection from misuse of authority by management. A second and related area which deserves additional study is the desirability of legislating rules of conduct that apply to institutional investment managers which specify that their primary responsibility is to the best interests of their investment clients, shareholders in the case of mutual funds, and not to their own management or advisory organization. This type of regulatory measure, coupled with severe penalties for noncompliance, would help eliminate the development of the various interest conflicts discussed earlier.

A final thought on the subject of investment company regulation. The mutual fund industry, while not perfect, is basically well regulated and well managed by competent and conscientious individuals. The industry can become even more respected by the effective contribution of governmental regulation, industry self-regulation, and shareholder involvement and concern.

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